No. 13220.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Carmelo J. Pellegrino,

Appellant,

vs.

William D. Nesbit, Hugh F. Colvin, James R. Bradburn and Consolidated Engineering Company,

Appellees.

BRIEF OF APPELLEES WILLIAM D. NESBIT, HUGH F. COLVIN AND JAMES R. BRADBURN.

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CARMELO J. PELLEGRINO,

Appellant,

vs.

WILLIAM D. NESBIT, HUGH F. COLVIN, JAMES R. BRADBURN and CONSOLIDATED ENGINEERING COMPANY,

Appellees.

BRIEF OF APPELLEES WILLIAM D. NESBIT, HUGH F. COLVIN AND JAMES R. BRADBURN.

I. STATEMENT OF THE CASE.

This appeal is from an order of the District Court of the United States for the Southern District of California, Central Division, made and entered on November 29, 1951, denying the motion of appellant, Carmelo J. Pellegrino, for permission to intervene, after judgment, in three actions. [Tr. of R. p. 118.]

On November 21, 1950, Consolidated Engineering Corporation, a California corporation, filed three actions in the District Court of the United States for the Southern

District of California, Central Division, against William D. Nesbit, Hugh F. Colvin and James R. Bradburn. The complaints in each of the three cases prayed for the recovery of profits realized by the defendant in each case through dealings in the stock of the plaintiff, under Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. A., Section 78p(b). Jurisdiction of the District Court was based upon Section 27 of the Act, U. S. C. A., Section 78aa. [Tr. of R. pp. 3, 27, 50.]

The action against William D. Nesbit bore the lowest filing number and was assigned to the Honorable Harry C. Westover, District Judge. Under the local rules of the District Court the other two actions were transferred to the same judge in view of the similarity of issues, although no order for consolidation has been made. Answers on behalf of each defendant were filed and thereafter, by leave of Court, amended answers were filed on April 30, 1951, and the case was heard upon the issues raised by the complaints in each case and such amended answers. [Tr. of R. pp. 7, 31, 54.]

On March 7, 1951, the Trial Court made and entered an order for pre-trial proceedings. Pursuant to this order plaintiff and defendant in each case on May 28, 1951, filed pre-trial stipulations, containing in each case a stipulation of facts, a statement of facts which the parties were unable to concede and a statement of plaintiff's objections to admissibility of certain stipulated facts. [Tr. of R. pp. 11, 44, 59.] Various pre-trial hearings and conferences were held and memoranda and briefs filed by the

parties and the cases were set for trial on July 20, 1951, on certain limited issues of fact raised by the allegations contained in the second, third, fourth and sixth defenses contained in the amended answer of the defendant in each case. The matter was tried on this date, with testimony being introduced on behalf of both parties in each case, and further stipulations of fact entered into in open court, following which the cases were submitted for decision on the issue of liability only. [Tr. of R. pp. 84, 92, 101.]

Thereafter the Securities and Exchange Commission moved the Trial Court for leave to file a brief as *amicus curiae,* which motion was unopposed and was granted on September 10, 1951. The Securities and Exchange Commission then filed a memorandum as *amicus curiae,* defendants filed memoranda in opposition thereto and the Securities and Exchange Commission filed a further informal memorandum in letter form.

On October 10, 1951, the Trial Judge made and entered his opinion covering all three cases, reviewing the law and the evidence and finding generally that there had been no violation of the purpose of the Securities Exchange Act of 1934 and that the plaintiff corporation was estopped by its conduct from recovering profits, if any, realized by the defendants. [Tr. of R. p. 76.]

On October 30, 1951, the Trial Court made and entered its findings of fact and conclusions of law and its judgment in each of the actions. No appeals have been taken from the judgments. [Tr. of R. pp. 84, 91, 92, 99, 101, 108.]

On November 27, 1951, Carmelo J. Pellegrino, the appellant, filed a notice of motion to intervene, without a supporting affidavit, and obtained an order shortening time to November 29, 1951, for the hearing of the motion. [Tr. of R. p. 109.] At the hearing appellant served and filed his affidavit in support of the application to intervene, summarizing certain correspondence between appellant's attorney, Morris J. Levy, Esq., and plaintiff's attorneys, and further summarizing certain conversations between appellant and his attorney. [Tr. of R. p. 112.] The motion was heard and denied. [Tr. of R. p. 117.]

On the same day, November 29, 1951, appellant filed his notice of appeal, appealing from the order denying him leave to intervene and on January 18, 1952, filed his statement of the point upon which he intends to rely on appeal, to-wit: that the District Court erred in denying his motion to intervene in each of the actions. [Tr. of R. pp. 118, 121.]

II.
STATEMENT OF ISSUES PRESENTED.

The sole issue presented on this appeal is whether the District Court erred in denying appellant's motion for leave to intervene.

III.
ARGUMENT.

A. The Sole Issue Presented on This Appeal Is Whether the District Court Erred in Denying Appellant's Motion for Leave to Intervene.

Appellant in this case has appealed from the order denying him leave to intervene. [Tr. of R. p. 118.] He has stated to this Court that the point upon which he intends to reply on this appeal is that the District Court erred in denying his motion to intervene. [Tr. of R. p. 121.]

Notwithstanding this state of the record, appellant in his opening brief now endeavors to argue that the District Court erred in granting the judgments, from which no appeal has been taken, and appellant seeks a reversal of these judgments. A considerable portion of his brief, as well as practically all of the brief filed by the Securities and Exchange Commission as *amicus curiae,* is devoted to the merits of the judgments and not to the propriety of the order denying intervention.

The purpose of the requirement that appellant file a statement of the points on which he intends to rely is "to enable the appellee to determine what additional portions of the record he shall specify." *Ashton v. Town of Deerfield Beach,* (C. C. A. 5, 1946) 155 F. 2d 40; *Keeley v. Mutual Life Insurance Company,* (C. C. A. 7, 1940) 113 F. 2d 633.

In reliance upon the notice of appeal and the statement of the point upon which appellant intends to rely, appellees have not designated additional portions of the record for use on this appeal. Appellant's attempt to expand the scope of this appeal is therefore prejudicial to appellees in addition to being clearly improper under Rule 19 (6) of the

Rules of the United States Court of Appeals for the Ninth Circuit and the decisions of this Court in *Western National Insurance Co. v. LeClare,* (C. C. A. 9, 1947) 163 F. 2d 337, and *Bank of America N. T. & S. A. v. Commissioner of Internal Revenue,* (C. C. A. 9, 1942) 126 F. 2d 48.

The only authority which appellant cites in support of his contention that the judgment itself may be considered is the case of *Park & Tilford, Inc. v. Schulte,* (C. C. A. 2, 1947) 160 F. 2d 984, *cert. den.,* 332 U. S. 761, 68 S. Ct. 64, 92 L. Ed. 347. In that case, however, there was an appeal already pending between the original parties and the Court of Appeals had before it the entire record of a case in which all issues had been tried. In the case at bar the record is incomplete in many respects, the evidence not being before this Court and factual issues raised by defendants' first and fifth defenses, in each case, remain untried and not completely covered by the stipulations. Further comment on these issues will be made below in this brief but, for the present purpose, it appears clear that the question of the merits of the judgment below is not properly before this Court.

B. Appellant Was Not Entitled to Intervene as a Matter of Right.

Appellant bases his right to intervene on Rule 24 (a) of the Federal Rules of Civil Procedure which provides as follows:

> "(a) *Intervention of right.* Upon timely application anyone shall be permitted to intervene in an action: . . . (2) when the representation of the applicant's interest by existing parties is or may be inadequate and the applicant is or may be bound by a judgment in the action; . . ."

Under this rule appellant must show that both of the required elements are present; *i.e.*, that representation by existing parties is or may be inadequate *and* that applicant is or may be bound by the judgment.

1. Appellant Has Made No Showing That the Representation of His Interest Is or May Be Inadequate.

Appellant was apparently satisfied with the adequacy of the representation of his interest by the corporation and by the attorneys for the corporation up to the time of the entry of the judgments. At least, no move to intervene was made by him during this period and there is no suggestion, either by appellant or by the Securities and Exchange Commission, that the prosecution of the action by the corporation and by its attorneys was not entirely diligent and proper. Such a claim, if made, would be absurd in view of the record of this case, affirmatively showing a complete presentation to the Court of the facts and the law favorable to the corporation [Tr. of R. pp. 84, 92, 101.]

Appellant's sole and only showing is that the board of directors of the corporation decided not to appeal. His position can only be supported if the decision not to appeal, in itself, sufficiently shows inadequacy of representation and a failure "diligently to prosecute" the action.

The Federal Courts have adopted a liberal policy allowing stockholders to intervene in actions under Section 16 (b) of the Securities Exchange Act were the defendants themselves are in a controlling position over the plaintiff. Thus in *Park & Tilford, Inc. v. Schulte, supra,*

cited by appellant, it appeared that the defendants owned a majority of the voting stock of the plaintiff corporation. The court properly and realistically allowed a minority stockholder to intervene, stating:

> "Under the circumstances here disclosed, the interests represented by defendants and their father were so dominant in the affairs of plaintiff that the District Court should have allowed stockholder representation to guard against even the appearance of any concerted action."

Intervention under these circumstances is unquestionably proper. Appellant and the Securities and Exchange Commission endeavor to create the impression that some similar situation exists in the case at bar. However, in this case the maximum combined stockholdings of all three of the appellees never exceeded a fraction over 3% of the outstanding stock of the plaintiff corporation [Tr. of R. pp. 19, 42, 67] and appellees were not directors of the plaintiff corporation at any of the times here involved [Tr. of R. pp. 4, 28, 51.]

A distinction must be borne in mind between officers and directors of a corporation. Identity of officers, directors and principal stockholders in many corporations often minimizes the differences in the legal status of these groups, but when this is not the case, the distinction is a real one. Management of a corporation lies in the board of directors, *California Corporations Code, Sec. 800; California Corporation Laws, Ballantine & Sterling,* 1949 Ed., p. 77. Ballantine & Sterling characterize the board as the "fountain of executive authority." The position of an officer of a corporation, when he is not a director or large shareholder, is nothing more than a hired employee, subject to the will and direction of the board of directors.

He is not legally entitled to participate in the deliberations of the board nor to have a voice, as officer, in the essential decisions establishing the policy of the corporation.

There is absolutely no showing of any kind made by appellant in this case that the appellees, or any one of them, exercised any influence or control of any kind whatsoever over the board of directors of Consolidated Engineering Corporation, or that the board of directors was in any way influenced by any solicitude for their welfare in any decisions made with respect to these actions. Presumably, and in fact, the board of directors acted only with the welfare of the shareholders in mind. Without any such showing of influence or control the basis for intervention on the ground of inadequacy of representation, in reliance on such decisions as the *Park & Tilford* case, wholly fails.

Appellant also claims that inadequacy of representation, is established from failure to appeal the judgments in these cases on the ground that this constitutes a failure "diligently to prosecute" the actions under the terms of Section 16(b) of the Act.

This phrase is nowhere defined in the Act and its meaning is left to construction by the courts. The words "diligence" and "diligently" have been construed in a great many cases and are almost universally taken to mean the kind of conduct, or degree of care, which prudent men would normally apply to their own concerns and affairs. The words have no specific content but always depend upon the facts and circumstances of the particular case. (26 C. J. S., pp. 1309-1311.) Nothing appears to indicate that any unusual meaning is to be attributed to these words as used in the Act.

Whether the board of directors of the plaintiff corporation acted "diligently" would therefore appear to depend upon the propriety of the action taken in view of all of the facts and circumstances which might properly be considered by the board as affecting the best interests of the shareholders. By ignoring substantial issues in these cases, other than that of estoppel, and by ignoring the factual basis for the decision of the trial court, appellant has presented a falsely oversimplified picture of the problems facing the board of directors in making its decision. Particularly, by ignoring the facts on which the trial court found an estoppel to be based, appellant has been able to point to other decisions of the Federal Courts and claim them to be "on all fours" with the cases at bar.

To point anything like a realistic picture of the considerations which might properly have led the board of directors to its decision not to appeal these cases would require going outside the record to a considerable extent. However, there is enough in the findings of fact and the opinion of the Trial Court to give a partial picture of the situation and reference will now be made to some of these circumstances, as revealed by the record, in order to give the Court a basis for determining whether the board of directors acted "diligently."

In its opinion, the Trial Court said:

> "Evidence in the case indicates that the idea of the stock option contracts originated with Philip S. Fogg, President of Consolidated Engineering Corporation, prior to the listing of plaintiff's stock on any national exchange as a means of retaining the services of the sixteen key men and as incentive to these men to use their best efforts for the benefit of the corporation. Included among the sixteen were the three defendants

in these actions, they being the only employees holding the conventional titles of officers of the corporation.

"At the time the option agreements were executed they had little value. After the options acquired a value (because of the rise in value of the stock) a meeting of the optionees was called by Mr. Fogg, at which meeting the tax problem incident to the exercise of the option agreements was brought to the attention of the option holders and suggestion was made that they be exercised annually to lessen the impact of tax accruing upon exercise of an option. The fact that optionees did not have additional resources sufficient to pay the tax and purchase stock, without concurrently selling a portion of their purchased stock, was discussed at the meeting. It was then made known to the optionees that they could (through a brokerage house of which one of the directors of plaintiff corporation was a partner) effect sales of stock in order to procure funds to take up their options.

"The various employees commenced taking up options, in most cases using the forms prepared or suggested by plaintiff corporation. At no time from the date of the first listing of the stock on an Exchange to the date of the filing of the actions herein did the management of the corporation, or anyone else, issue any bulletin, circular, letter, notice or any other document, calling the employees' attention to restrictions upon them under the Securities Exchange Act relative to purchase and sale of stock within the six months' period."

"If ever there was a case where equity and good conscience 'would forbid the relief sought', it seems to the Court that the necessary facts are present in these cases at bar, inasmuch as it is established that in lieu of paying additional salary to retain the services of these employees, the option agreements were given;

> that the transaction was initiated and handled by plaintiff corporation herein and, before consummation, had to be approved by the Corporation Commissioner of the State of California; that nothing was ever intimated to any of the defendants that if they exercised their options and purchased any stock, reselling within six months at a profit, they would have to pay to the corporation the profits realized. As all the parties were acting in good faith, deeming the agreement valid, it would seem most inequitable now, after the corporation has had the benefit and advantage of the option agreements for several years, to allow plaintiff corporation to recover from defendants in accordance with the prayers of its complaints." [Tr. of R. pp. 77-79.]

None of the cases cited by appellant nor any of the cases under the Securities Exchange Act of 1934 discovered by the parties or the Securities and Exchange Commission in their research on the legal problems involved in this case reflect a factual situation remotely similar to that which was revealed to the trial court in this litigation, and a part of which is summarized by the trial court in the above quotation from its opinion.

At the trial level it was assumed by defendants and by the Trial Court that these cases were brought in equity under the provisions of Section 16(b) providing that suit to recover profits may be instituted "at law or in equity" [Tr. of R. p. 83]. It now appears for the first time that the Trial Court was mistaken in assuming that the Securities and Exchange Commission agreed with this conclusion, as the Commission in its brief (S. E. C. Br. p. 7, footnote 3) apparently disagrees, although no reason or authority is stated showing the Trial Court to be wrong.

In *Arbetman v. Playford & Alaska Airlines, Inc.* (D. C. S. D. N. Y., 1949), reported in Commerce Clearing House Federal Securities Law Reporter, paragraph 90439, an action was brought by a shareholder under Section 16(b) of the Act. Plaintiff made no demand for a jury trial but the defendant did and plaintiff's motion to vacate defendant's demand was granted by the District Court. The Court called attention to the fact that such an action was not for the direct benefit of the plaintiff but for the benefit of the corporation and its shareholders and was thus a derivative suit in the nature of an equitable action. Under Section 16(b) of the Act plaintiff had a choice of bringing his action at law or in equity and, by failing to seek a jury trial, had exercised this choice to bring his action in equity.

This question is probably of no great importance, since all actions in the district courts are now "civil actions" and the distinction between law and equity has largely been abolished by Rule 2 of the Federal Rules of Civil Procedure. Equitable defenses may now be interposed to legal actions. (Federal Practice and Procedure, Rules Edition, Barron and Holtzoff, Vol. 1, Sec. 141. See *Maltz v. Sax* (C. C. A. 7, 1943), 134 F. 2d ......, cert. den. 319 U. S. 772, 63 S. C. 1437, 87 L. Ed. 1720, and *Bruckman v. Hollzer* (C. C. A. 9, 1946), 152 F. 2d 730.) The distinction, in the federal courts, has meaning only with reference to the right to a jury trial. (Rule 38(a), Federal Rules of Civil Procedure; *Bruckman v. Hollzer, supra.*) Moreover, although "equitable estoppel" originated in the courts of equity, it is generally a defense at law, even where the old distinctions between law and equity are preserved. (31 C. J. S., p. 252.) The Trial Court was therefore unquestionably correct in considering an "equitable" defense in this case, particularly where the

nature of the action is similar to a stockholder's derivative suit, traditionally an equitable proceeding. (*United Copper Securities Co. v. Amalgamated Copper Co.* (1917), 244 U. S. 261, 37 S. Ct. 509, 61 L. Ed. 1119.)

Appellant has cited the case of *Park & Tilford v. Schulte, supra,* for the proposition that estoppel does not apply in this type of litigation. The reference of the Court in that case to "estoppel" is a verbal coincidence and nothing more.

The "estoppel" that was the subject of comment in that decision was not an estoppel *in pais* arising from the conduct of the parties prior to the commencement of the litigation, but concerned a reversal of the legal position of the intervenor and the Securities and Exchange Commission, during the course of the appeal, with respect to the proper method for measuring damages. There is not the remotest resemblance of this situation to the "estoppel" in the case at bar despite the fact that the same word is used in both connections.

In its brief, page 11, the Securities and Exchange Commission has cited a decision of the District Court for the Eastern District of Louisiana, rendered April 2, 1952, as authority for the proposition that estoppel is not available as a defense in this type of action. (*Jefferson Lake Sulphur Co. v. Walet* (D. C. E. D. La., 1952), ... Fed. Supp. ......), reported in Commerce Clearing House Federal Securities Law Reporter, paragraph 90526.) This decision was, of course, rendered long after the judgments in the case at bar. In the Louisiana case the defendant was the president and a director of the plaintiff corporation who had purchased its shares, in part on an exchange and in part under an option, and made sales of shares

within a 6 months' period. A defense of estoppel was interposed based on the argument that the corporation had waived its rights by executing the option agreement in the first place and that the purpose of the agreement was to give the president a profit on short swing transactions as additional compensation.

No claim has at any time been made by the appellees in the cases at bar that there was any estoppel against the corporation merely by reason of the execution of the option agreements or the intention on the part of the corporation that through the option agreements the appellees would receive additional compensation for their services.

Although the testimony in the case at bar is not before the appellate court, a part of the facts on which the Trial Court based its decision are disclosed by the Trial Court's opinion and the findings of fact made. [Tr. of R. pp. 76, 84, 92, 101.] It was on these facts, and not on the fact of the execution of the option agreement itself, that estoppel was based.

Briefly, it appears that after the options had acquired a value because of the rise in value of the stock there was a meeting of all the optionees called by the president of the corporation. At this meeting there was brought to the attention of the optionees the tax problem which existed by reason of the fact that a profit for tax purposes was, under the law at that time, realized upon the exercise of the option. The optionees were advised to exercise their options annually in order to lessen the impact of the tax. There was discussion of the fact that the optionees did not have sufficient resources of their own to pay the tax and buy the stock, unless they concurrenty sold a portion of the stock taken up under the option agreements.

It was made known to the optionees that they could make such sales of stock in order to procure funds to take up their options through a brokerage house of which one of the directors of the plaintiff corporation was a partner.

The forms to be used for carrying out these transactions were prepared or suggested by the plaintiff corporation and the corporation at no time called the employees' attention to any restrictions upon them under the Securities and Exchange Act. Although all of the parties were acting in the best good faith throughout, the effect of the actions of the principal officers and directors of the corporation was to lay a veritable trap for the employees of the corporation who bore the titles of officers. The effect of the transaction, if the view of the Securities and Exchange Commission is followed, would be that the corporation would obtain the benefit of the efforts of these appellees, which contributed substantially to the success of the company, and in return therefor would penalize them heavily. It must be remembered that these employees were taxable upon any profits in these transactions and that, if forced to return such profits to the corporation, no tax deduction is allowed.

The Trial Court's conclusion was that:

> "If ever there was a case where equity and good conscience 'would forbid the relief sought,' it seems to the Court that the necessary facts are present in these cases . . ." [Tr. of R. p. 82.]

Although incomplete, enough of the factual situation is shown by the above to differentiate the case clearly from the cases cited by appellant and which appellant claims to be "on all fours" or determinative of the issues in this case. None of the factual elements here were to any

degree present in *Steinberg v. Sharpe* (C. A. 2, 1951), 190 F. 2d 82; *Park & Tilford, Inc. v. Schulte, supra; Smolowe v. Delendo Corp.* (C. A. 2, 1943), 136 F. 2d 231, cert. den. 320 U. S. 751, 64 S. Ct. 56, 88 L. Ed. 446, or *Gratz v. Claughton* (C. A. 2, 1951), 187 F. 2d 46, cert. den. 341 U. S. 920, 71 S. Ct. 741, 95 L. Ed. 1353.

Appellant and the Securities and Exchange Commission further assert that the defense of estoppel is inapplicable because of the provision in Section 29(a) of the Act (15 U. S. C. A. 78cc(a)), providing that "any condition, stipulation, or provision binding any person to waive compliance with any provision of this act shall be void." The argument is that since the corporation cannot be prevented from recovery by an express waiver, neither can an implied waiver be effective for this purpose.

This argument wholly misses the distinction between a "waiver" and an "estoppel." At no time in the case at bar have appellees contended that it would be possible for the corporation to make an express waiver of the rights given to it under Section 16(b). It is obvious that any such attempt on its part would show knowledge of the provisions of Section 16(b) on the part of both parties and would be affirmative evidence of bad faith. However, there is a clear-cut distinction between a waiver of the type contemplated by the Act and an estoppel which arises when conduct of one of the parties makes judgment in favor of that party inequitable. A waiver is a "voluntary relinquishment of a known right" while an estoppel arises when one party, by its conduct, has led another party to take certain steps to his injury and has accepted the benefit of the steps so taken. An estoppel may arise even though no waiver in advance would be valid. (See

67 C. J. S., p. 289; 31 C. J. S., pp. 245-246; 56 Am. Jur., pp. 102-104.)

Although the Trial Court rested its decision on the basis of an estoppel, there were many other defenses raised by the defendants in these actions which would have required determination in the event that the Trial Court had felt that an estoppel did not apply. Without going at length into these issues, appellees will merely refer to a few which were briefed at length and argued in the trial below as applicable on the pleadings in these cases. One such issue is the effect of the community property laws of the State of California under Section 16(b) of the Act, this being a point on which considerable research and briefing was done by the parties and by the Security and Exchange Commission. Another and difficult issue was the question of the application of Section 16(b) to an employment contract covering the accrual of options over a period of years, entered into prior to the listing of the corporation stock on any national securities exchange, and the effect between the parties of such subsequent listing which, under the six months rule of Section 16(b) would prevent employees from selling any portion of the stock purchased during the entire term of their employment. Another issue arose from defendants' contention that the legal effect of the issuance by the Securities and Exchange Commission of its rule X-16B-6, effective November 29, 1950, was to exempt the transactions here in question from the operation of Section 16(b). A further issue in the case was the applicability of Section 16(b) to stock acquired by one of the defendants through conversion of bonds of the corporation purchased prior to the execution of the option agreements. In addition to the issues affecting legal liability, there were many and difficult issues

with respect to the proper measure of damages, if any, if liability were established, defendants disagreeing that any values stated in the stipulation of facts in each of the three cases were necessarily determinative of the value of their options on the accrual dates, the dates of the issuance of the shares, the dates six months prior or subsequent to the dates of any sale or any other relevant dates involved in the transactions.

Unless the words "diligently to prosecute" as used in the Securities Exchange Act are given some strange and novel meaning, the board of directors of the plaintiff corporation was entitled to consider the expense and uncertainty of litigating all of these issues, as against any possible benefit to the company which might come from recovery in the cases, and they were further entitled to consider the effect on the company of the cases in every way which bore upon the interest of the shareholders. Presumably the board of directors was acquainted with all of these matters, through their counsel. At least appellant has made no showing and has intimated nothing to the contrary.

The decision of a board of directors of a corporation with respect to litigation appears to be in no respect essentially different from a decision as to any other corporate matter. This is true notwithstanding that a statute such as the Securities Exchange Act is involved. In *United Copper Securities Co. v. Amalgamated Copper Co.,* 244 U. S. 261, 37 S. Ct. 509, 61 L. Ed. 1119 (1917), the Sherman Anti-Trust Law was involved. A stockholder had made demand upon the plaintiff corporation to bring suit to recover treble damages. The corporation had refused and the stockholder had brought suit in its

name. Dismissal of the complaint was affirmed by the Supreme Court. The Supreme Court stated:

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by the vote of the shareholders. For aught that appears, the course pursued by the directors has the approval of all of the stockholders except the plaintiffs. The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation."

The Supreme Court went on to point out that under the long settled rule a derivative action by a shareholder was equitable in nature and that this rule had not been changed by the Sherman Anti-Trust Law, although such law provided an action for damages.

In the case of *Findley v. Garrett,* 109 A. C. A. 161, 240 P. 2d 421 (1952), the California court affirmed a dismissal of a shareholders derivative action based on allegations of fraud, conspiracy and bad faith on the part of a majority of the directors. In the course of its opinion the court said:

> "The power to manage the affairs of a corporation is vested in the board of directors. Scott v. Los Angeles Mountain Park Co., 92 Cal. App. 258, 264, 267 P. 914. Where a board of directors, in refusing to commence an action to redress an alleged wrong against a corporation, acts in good faith within the scope of its discretionary power and reasonably be-

lieves its refusal to commence the action is good business judgment in the best interest of the corporation, a stockholder is not authorized to interfere with such discretion by commencing the action. See Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 557, 274 P. 597. In the case last cited it was said at page 557 of 96 Cal. App. at page 600 of 274 P.: '(C)onduct of directors in the management of the affairs of a corporation is not subject to attack by minority stockholders . . . where such acts are discretionary and are performed in good faith, reasonably believing them to be for the best interest of the corporation.' Also, on said page, it was said: 'Good business judgment would seem to recommend the safe and sure plan which was adopted by the directors . . . At least the transaction appears to be a discretionary matter, and, if so, affords a stockholder no authority to challenge it in this equitable action. Every presumption is in favor of the good faith of the directors. Interference with such discretion is not warranted in doubtful cases.' . . .

"Notwithstanding the insufficiency of the allegations of fraud and bad faith, it was necessary for the court to consider whether, on the facts alleged, the refusal of the directors to prosecute the claims was so clearly against the interests of the corporation that it must be concluded that the decision of the directors did not represent their honest and independent judgment. The facts alleged would not have justified such a conclusion. It was a question of business whether the transactions over a twelve-year period should be investigated and prosecuted. Directors have the same discretion with respect to the prosecution of claims on behalf of the corporation as they have in other business matters. In this respect the fact that a claim may be founded in fraud does not

> differentiate it from other claims. Refusal to sue on a fraud claim is not, as plaintiffs contend a ratification of fraud. The mere fact that a recovery for the corporation would probably result from litigation does not require that an action be commenced to enforce the claim. Even if it appeared to the directors of Douglas that at the end of protracted litigation substantial sums could be recovered from some or all of the defendants, that fact alone would not have made it the duty of the directors to authorize the commencement of an action. It would have made it their duty to weigh the advantages of a probable recovery against the cost in money, time and disruption of the business of the company which litigation would entail."

In the case at bar there was obviously ample reason for the board of directors to make the decision which it did. Appellees had no opportunity to investigate or to present as a part of this record any of the facts which the board actually considered, as the motion by appellant was made too late to allow time for this purpose. However, it is always presumed that a board of directors acts in the interest of the corporation in good faith, and there is absolutely no showing or intimation to the contrary here. Unless the Securities Exchange Act of 1934 by implication repealed all of the law applicable to the internal management of corporations, no showing of any sort has been made that the failure to appeal was the failure of diligence in prosecution within the meaning of the Act and was not done in the best interests of the corporation and its shareholders, in complete good faith. Under these circumstances appellant has failed completely to bring himself within the requirement that his representation by the corporation was or might be inadequate.

2. Appellant Has Made No Showing of Any Substantial Interest Which Is Affected by the Judgments in These Actions.

In a sense it is true that appellant, as a shareholder of plaintiff corporation, will be bound by the judgments entered in these three cases. This is as true as the statement that any judgment for or against a corporation, any contract entered into by a corporation or any other act by a corporation, in a sense, binds its shareholders. However, the showing of prejudice to appellant by these judgments must certainly reveal a substantial interest and appellant cannot invoke the rule as to intervention of right to protect a trivial, inconsequential or improper interest.

The case of *Wolpe v. Poretsky* (C. A. D. C., 1944), 144 F. 2d 505, cert. den. 323 U. S. 777, 65 S. Ct. 190, 89 L. Ed. 621, indicates the type of situation and the type of interest to which the rule was undoubtedly meant to apply. In that case a judgment had been entered enjoining the members of a zoning commission from carrying into effect a zoning order. Adjoining property owners were accorded the right to intervene, after the decree was entered, upon a showing that the zoning commission, without any public hearing or other notice to the property owners affected, had voted not to make an appeal, and that the properties of the intervenors would be seriously damaged by the ruling of the trial court. In this case a proper showing was made that the commission had not adequately considered the interests of the intervenors and that such interests were substantial and real.

The other cases cited by appellant, *Bronson v. LaCrosse & Milwaukee R. R. Co.*, 2 Wall. 283, 17 L. Ed. 725 (1864); *Klein v. Nu-Way Shoe Co., Inc.* (C. C. A. 2,

1943), 136 F. 2d 986, and *Golconda Petroleum Corporation v. Petrol Corporation* (D. C. S. D. Calif., 1942), 46 Fed. Supp. 23, were instances of intervention to protect substantial interests. In none of these cases was intervention sought to protect a trivial interest or to gain an advantage unconnected with the protection of the interest involved.

The case at bar reveals quite a different situation. In his affidavit in support of his motion to intervene, appellant claims to be the owner of two shares of the common stock of plaintiff corporation. Appellees had no opportunity to put into the record the total amount of outstanding stock of plaintiff corporation on the date of the judgment, but the record does give at least some information in this respect which may be utilized for the purpose of the present argument. The stipulations of fact show that at all times mentioned in the complaint plaintiff had a minimum of 174,190 shares outstanding. [Tr. of R. pp. 19, 42, 67.]

Under Rule X-16B-6 of the Securities and Exchange Commission any recovery in these cases would in any event be limited to the difference between the sales price and the market value of the securities sold between a date 6 month before and a date 6 months after the date of sale. If the judgments in these cases were reversed, if every defense asserted by the defendants was disregarded and if all of defendants' contentions with respect to the measure of damages were also disregarded, the maximum possible gross recovery to the plaintiff corporation in the three cases, under the Securities and Exchange Commission rule would be as follows: William D. Nesbitt $5,942.50, Hugh F. Colvin $4,444.00, James R. Bradburn $7,091.25, or a total of $17,477.75.

The application of the rules established for determining damages and of the rule of the Securities and Exchange Commission is somewhat difficult on the facts stipulated but appellees believe that the figures quoted are accurate within reasonably narrow limits and that it is unnecessary for present purposes to set forth at length herein the calculations from which these figures are derived.

Assuming, therefore, that the plaintiff corporation recovered the maximum possible amount against all three defendants and assuming, contrary to fact, that the total outstanding shares of plaintiff corporation is not more than as stated, the gross recovery applicable to appellant's stock interest would be 2/174,190 of $17,477.75 or 20¢.

Appellant has made no showing that it is in the best interests of the corporation or any of its shareholders to pursue this litigation. As noted by the Supreme Court in the *United Copper Securities Co.* case, *supra:* "For aught that appears, the course pursued by the directors has the approval of all of the stockholders except the plaintiffs" (here the appellant). Appellant's own stake in the case is of such a nature that the rule of *de minimis non curat lex* might well be applied and his appeal dismissed. (*In re United Light and Power Company* (D. C. D. Del., 1943), 51 Fed. Supp. 217; *Anderson v. Mt. Clemens Pottery Company* (1946), 328 U. S. 680, 66 S. Ct. 1187, 90 L. Ed. 1515; *Frank v. Wilson & Co., Inc.* (C. A. 7, 1949), 172 F. 2d 712, and *Porter v. Rushing* (D. C. W. D., Ark., 1946), 65 Fed. Supp. 759.)

According to appellant's affidavit, appellant purchased his shares on September 11, 1950, and on October 2, 1950, his attorney, Morris J. Levy, Esq., made demand upon the plaintiff corporation that suit be brought against

defendants. It certainly "could be assumed" that the shares were purchased for the sole purpose of instigating these actions. [See Opinion of the Trial Court, Tr. of R. p. 79.] It can only be assumed that appellant is not the real party in interest here and that his effort to intervene is nothing more than an attempt to foster litigation and compel the payment of fees to his attorney.

This type of activity on the part of an attorney is the kind usually pursued at the risk of disbarment (see Canons of Professional Ethics of American Bar Association, Canon No. 28), but is condoned in cases coming within the scope of Section 16(b) of the Securities Exchange Act of 1934 because Congress has not seen fit to provide other methods of enforcement of the provisions of this section. However, such conduct may make appellant subject to the defense that his hands are not clean. See *Magida v. Continental Can Company* (D. C. S. D. N. Y., 1951), 12 F. R. D. 74, in which the Trial Court denied a motion for summary judgment made by appellant's attorney on behalf of his client in that case, and in which the Court said that as to the circumstances under which plaintiff acquired his 10 shares "it may be that facts will develop at the trial which will call for an application of the doctrine of 'unclean hands.'"

The defense of "unclean hands" may even be considered by the Court on its own motion and has been held to apply despite the public interest in the statute under which the action is brought. For such application in the case of a violation of the Sherman Anti-Trust Law, see *Maltz v. Sax, supra.*

Neither the trivial interest of appellant in the judgments in these cases or the interest of his attorney in

the fees which might be recovered if the judgments were reversed are such interests as entitle appellant to intervene as a matter of right, on the pretext that he will be bound by these judgments.

C. The District Court Did Not Abuse Its Discretion in Denying Appellant Leave to Intervene.

If appellees are correct and appellant is not entitled to intervene as a matter of right, then the granting or denying of appellant's motion was a matter entirely within the discretion of the Trial Court and its action will not be disturbed except for a clear abuse of discretion, if the order is appealable at all. Considerations already stated in this brief would uphold the Trial Court in finding a wholly insufficient showing by appellant of any grounds justifying permissive intervention.

Stallings v. Conn (C. C. A. 5, 1934), 74 F. 2d 189;

Cameron v. Harvard College (C. C. A. 1, 1946), 157 F. 2d 993;

Delno v. Market Street Ry. Co. (C. C. A. 9, 1942), 124 F. 2d 965;

Allen Calculators, Inc. v. The National Cash Register Co. (1944), 322 U. S. 137, 64 S. Ct. 905, 88 L. Ed. 1188.

Regardless of whether intervention is a matter of right or permissive, Rule 24(a) requires timely application. Whether an application is timely is a matter for the Trial

Court and its decision will not be disturbed on appeal unless there is a clear abuse of discretion.

> *Federal Practice and Procedure, Rules Edition, Barron & Holtzoff,* Vol. 2, page 206;
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> *United States v. Columbia Gas & Elec. Corp.* (D. C. D. Del., 1939), 27 Fed. Supp. 116, app. dism. 108 F. 2d 614, cert. den. 309 U. S. 687, 60 S. Ct. 887, 84 L. Ed. 1030;
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> *Miami County National Bank v. Bancroft* (C. C. A. 10, 1941), 121 F. 2d 921;
>
> *Mullins v. De Soto Securities Co., Inc.* (D. C. W. D. La., 1942), 2 F. R. D. 502, aff'd on this point, 136 F. 2d 55;
>
> *Consolidated Gas Elec. L. & P. Co. v. Pennsylvania W. & P. Co.* (C. A. 4, 1952), 194 F. 2d 89;
>
> *Stallings v. Conn, supra;*
>
> *Delno v. Market Street Ry. Co., supra.*

The application in this case was not timely and appellees were substantially prejudiced by the filing of the supporting affidavit on the day of the hearing, giving appellees no opportunity to file answering affidavits for consideration by the appellate court. It must be remembered that appellant could have intervened in this action at any time after November 21, 1950. (*Twentieth Century Fox Film Co. v. Jenkins* (D. C. S. D. N. Y., 1947), 7 F. R. D. 197.) However it has been held that intervention at this point will not justify a duplication

of attorney's fees. (*Berkey & Gay Furniture Co. v. Wigmore* (D. C. S. D. N. Y., April 15, 1947) reported in Commerce Clearing House Federal Securities Law Reporter, paragraph 90376.) At any rate, appellant made no move to intervene during the period of more than eleven months between the date of filing the action and the date of the judgment. By appellant's own affidavit in support of his application to intervene, it appears that he had knowledge that the Trial Court had rendered its decision dismissing the suits within a day or so after October 29, 1951. [Tr. of R. p. 114.] If appellant desired to protect his right to appeal, he could have made application immediately after such notice, which would have given appellees the ten-day period required by the rules of court to investigate the matters contained in appellant's moving affidavits and to prepare answering affidavits for the record. If a motion on two days' notice, without supporting affidavits, noticed for the day on which the appeal must be filed, is timely, then it is impossible to conceive of any application being untimely.

Whether or not intervention is a matter of right or permissive, application for leave to intervene must be made in proper form, with proper supporting documents, and in accordance with the rules of court. (*Miami County National Bank v. Bancroft, sura.*)

In this case there was a complete failure to comply with these requirements. No supporting affidavit was served with the notice of motion as required by Rule 6(d) of the

Federal Rules of Civil Procedure. The notice of motion did not "state with particularity the grounds therefor" as required by Rule 7(b)(1) of the Federal Rules of Civil Procedure. The notice of motion and the order shortening time thereof did not comply with Rule 3(b) of the Rules of Civil Procedure for the United States District Court for the Southern District of California. No memorandum of points and authorities was served with the notice of motion as required by Rule 3(d) of the Local Rules. Under the last mentioned rule, failure by the moving parties so to serve and file affidavits and a memorandum of points and authorities is deemed a waiver of the motion.

The affidavit in support of the motion, as finally served and filed on the morning of the hearing, is wholly insufficient and improper. Apart from the statement that affiant is the owner of two shares of the plaintiff corporation, the affidavit consists of summaries of unproduced letters between affiant's attorney and plaintiff's attorneys and references to conversations between affiant and his attorneys. Affiant does not state that the letters summarized were the only letters between the parties, which appellees understand is not the case. The entire affidavit is an incompetent and hearsay statement of matters not within the knowledge of appellees and which they had no opportunity to investigate or contradict.

Under these circumstances the Trial Court properly exercised its discretion and no abuse of discretion has been shown.

D. Conclusion.

The narrow issue before this Court is whether the Trial Court erred in denying a motion for leave to intervene. Appellees believe that it has been shown that appellant made no sufficient showing to entitle him to intervene and that the Trial Court's order was entirely correct.

Appellant and the Securities and Exchange Commission have endeavored to bring before this Court the question of the propriety of the judgments entered in these actions. While this issue is not properly before the Court, the record of the litigation must, of course, furnish the background for the determination of the narrow issue which is to be resolved.

The positions of the respective parties are clear. The plaintiff corporation and its board of directors are concerned for the interests of its shareholders. To the Securities and Exchange Commission, according to its brief: "The corporation and its security holders are but instruments to vindicate the statutory policy against short-term trading by insiders." The appellant, in turn, with his two shares of stock, is but an instrument for the recovery of attorney's fees by his attorney. Neither the Securities and Exchange Commission nor appellant nor appellant's attorney care one whit for the interest of the real parties plaintiff, the shareholders of the plaintiff corporation.

There is no question of the desirability of enforcing the Securities Exchange Act of 1934 so as to accomplish

its legitimate objectives and the purpose of the Congress in its enactment. Appellees refuse to believe that such an act may not be administered, and such purposes accomplished by the courts, without allowing it to become an instrument of oppression against honest men. Nor do appellees believe that the courts should allow the act to be used for such purposes as appellant is seeking to pursue here.

The application for leave to intervene was untimely, appellant has made a totally insufficient showing of any real reason for intervention, and the decision of the Trial Court on his application should be upheld.

Respectfully submitted,

Willis Sargent and
Sidney H. Wyse,

Attorneys for Appellees William D. Nesbit, Hugh F. Colvin and James R. Bradburn.